SECURITIES LENDING AND INVESTOR PROTECTION CONCERNS: CASH COLLATERAL REINVESTMENT; BORROWER DEFAULT; LENDING AGENT COMPENSATION AND FEE SPLITS; AND PROXY VOTING

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I. Introduction

Securities Lending is a financial tool that has been utilized for over four decades. As it has developed into a critical element to market liquidity, it has not lost its fundamental purpose for Lenders—incremental income with limited risk. The maximization of revenue, although a daily goal, is secondary to the safety of the principal of cash collateral and operational efficiency. However, recent market volatility has increased the perceived potential risks associated with lending.

Securities Lending market participants work together to build upon lending's structural safeguards to address investor protection concerns. Greater flexibility and transparency in lending programs, clearly outlining the Lender's structural control, support the mitigation of risks for Lenders.

In addition, as Lenders structure their securities lending programs to fall within their general investment guidelines, (by matching the securities lending cash collateral investments with their overall investment objectives and requirements and factoring their borrower approvals in their overall examination of counter party exposure), Lenders can earn securities lending revenue without expanding their overall institutional risk profile.

II. Investor Protection Concerns with Cash Collateral Reinvestment

In the US, Lenders typically receive cash collateral when lending securities and are responsible for setting the investment parameters for such cash. As the principal risk of loss on cash collateral reinvestments remains with the Lender, these investments should not expand the Lender's overall risk profile. By providing a program whereby Lenders can customize their investment guidelines, they will have a great deal of control of their investment exposures. In addition, to the extent investments are within the overall approved investment philosophy and parameters set by the Lender for its total activities, the Lender is in a better position to balance and match its complete exposure to reduce potential risks. Factors that support Lender protection for this aspect of lending include:

a. Lender Directed Investments

- Lenders should be given the ability to create/design a customized cash collateral investment program that meets their own risk appetite and investment objectives/parameters.

- The Lender should have the ability to set detailed investment parameters, including, but not limited to, credit quality parameters, specific concentration limits for any given investment type or issuer, duration limits on both individual investments and the aggregate portfolio, as well as the ability to restrict or limit exposure to individual issuers, guarantors, or counterparties.

b. Cash Collateral Investment Models

- There are various models utilized for cash collateral investment. Separately managed accounts can provide flexibility and control for Lenders. Lenders select all of the investment criteria that they believe are appropriate for the given lending program. In addition, the Lender has the ability to change the criteria as conditions warrant.
- Lenders should also have the option to invest in collective investment vehicles or to invest cash collateral independently. These models can be used exclusively or together with a separately managed account model. The selected investment model should match the Lender's risk profile and the investor's overall investment parameters.
- A systemic compliance module is essential in supporting cash collateral investment, ensuring the Lender of automatic checks and balances of their specific requirements at the time investments are purchased.

c. Flexibility

The cash collateral investment guidelines should be flexible so that the Lender is able to adjust the cash collateral investment portfolio if it feels that it is in its best interest to do so.

d. Transparency

A key factor for Lenders is the ability to monitor their exposure at all times. For this reason the lending agent should maintain a reporting system that creates transparency of the investment portfolio at all times. Web-based reporting systems support full transparency of investments, earnings and performance by asset class. In addition, periodic reviews and discussions regarding the investment portfolio are useful tools implemented by the lending agent to ensure transparency. Again, client control, and specifically the ability to customize reporting, is extremely important.

e. Return

Optimization of the return on the cash collateral within the given guidelines can only be viewed as part of the objective. When considering revenue targets, the Lender must take into account its risk profile and always factor into these targets the safety of principal.

f. Other Options to USD Cash collateral

- As there are various types of Lenders participating in the securities lending market, there are various regulatory and other restrictions that limit the types of permitted collateral for select Lender categories. However, with a broad menu of collateral options, a Lender is able to lend to a broader audience of borrowers and increase its opportunity to match the risk of the asset with the liability side of the transaction. OECD Cash or debt can broaden the investment and loan options, as well as providing diversification that can offset risk.
- In addition to cash and debt instruments, equities as collateral may also present increased opportunity. Outside of the US, equity collateral has increased the borrower base, as well as the range of permitted (quality) collateral for lenders. Exchange traded equities provide more robust pricing than over-the-counter traded debt securities. In addition, the correlation in pricing of loaned equities to equity collateral can be viewed as a risk mitigant in the event of default.

III. Investor Protection Concerns with Borrower Defaults

The counterparty risk associated with securities lending is a well-hedged risk. There are several structural, operational and contractual protections within the standard lending format designed to provide protection against borrower default. Key among these factors are:

a. Lender Directed Borrower Selection and Limitations

- A key control against borrower default is selection of the principal counterparty. As principal to the transaction, the Lender controls the counterparty selection and should have the ability to monitor and change its exposure to any borrower at any time.
- In addition to approving the counterparty, the Lender should be in a position to limit (on a dollar basis or percentage of portfolio basis) loans to any borrower. By having this control, the Lender can balance its overall exposure to a counterparty, factoring the

loan exposure into its total transaction exposure (for securities lending and non-lending activity) with a particular counterparty.

b. Full Collateralization

- Securities loans are fully collateralized transactions. Whether with cash or other permitted collateral, the Lender should maintain collateral equal to at least 100% of the value of the loaned securities. In addition to ensuring that the loan is fully collateralized, the loan agreement should also provide that: (1) the Lender has immediate rights to the collateral in the event of a default, to provide prompt replacement of loaned securities and reduce the risk of change in the market price and (2) collateral can also be applied to other applicable losses resulting from the default, such as distributions payable at the time of default or other income due the Lender.
- The daily mark-to-market process serves as a consistent check and balance for ensuring full collateralization at all times during the term of a loan.

c. Contractual Protections

- The lending agreement should clearly outline the triggers for borrower default and the remedies available to the Lender. In addition to the filing of a petition in bankruptcy or reorganization, the Lender's rights to declare a default may be triggered by failure of the Borrower to deliver additional collateral or to return collateral upon a request for termination, failure to pay distributions, misrepresentations or other breaches of the terms of the loan agreement, or failure of financial tests/requirements.

d. Indemnification

- The lending agent in many cases offers the Lender a second layer of protection in the form of an indemnification against loss due to borrower default. Lenders should carefully consider the indemnity coverage, conditions required for triggering the indemnity and the timing of indemnity payments.

e. Operational Procedures

Stringent operational procedures are critical in exercising the rights provided by the contracts. Lender awareness of the systemic controls and specific operational processes will assist in the event such processes must be utilized in the case of a default.

IV. Investor Protection Concerns and Lending Agent Compensation and Fee Splits for US Domestic Lending

Lenders should recognize in reviewing agency compensation and fee splits that there is no standard pricing. Lending agent compensation for US lending activity requires comprehensive modeling because it must consider quantitative and qualitative factors. It is important that Lenders are confident when looking at agency compensation that they are not comparing apples to oranges. The focus should always be on the services offered.

a. Some of the quantitative factors that enter into agent compensation and fee splits include: overall gross opportunity, turnover rate and portfolio composition.

b. Qualitative factors include: service requirements, indemnification, and client restrictions.

V. Investor Protection Concerns and Proxy Voting

In a securities lending transaction, the borrower generally receives incidents of ownership, including the ability to vote the borrowed shares. Accordingly, the lending agent should work with the Lender to accommodate the Lender's voting strategies, including through recall of shares if necessary.

a. Flexibility
   - The lending agent should maintain processes that are flexible so that the Lender can have options for voting proxies or not voting proxies.
   - Various approaches can be implemented to address Lenders' needs to participate in voting, including vote-by-vote instructions; policies not to participate in purely corporate housekeeping votes; and segregating a sub-set of assets on the books of the agent that are recalled for voting. The effectiveness of recalling securities for voting proxies may be impacted by the timing of the issuer's meeting announcement.

b. Impact to Revenue
   - Participation in proxy voting can affect securities lending revenue.

VI. Other Factors that Impact Investor Protection

Additional factors support investor protection in connection with securities lending. A central theme for these additional factors is communication. While contracts and systems provide a framework, in the end it is the participating parties that ensure investor protection. As new challenges result from market changes and demands, it is essential that the Lender, their advisors, lending agent, borrowing counterparties and regulatory bodies maintain open dialogue to make the securities lending financial tool responsive to changing market needs, at the same time as maintaining the fundamental principles (incremental income with limited risk) on which this market has been established. For this reason, Lender protection must be built on a foundation of continuous Lender communication of issues and goals.

a. Regulatory Responsiveness

Dialogue between Lenders and their regulators can create more responsive regulatory action that speaks to the events and needs in the market that directly impact Lenders. One notable example is IRS Revenue Procedures 2008-63, which provided that when cash collateral pledged against a securities loan on which the borrower has defaulted is utilized for the purchase of identical securities, the Lender would not recognize a gain or loss on borrowed securities provided that the collateral is applied within a practicable time period. This IRS action, taken at the time of the Lehman bankruptcy, directly addressed a specific, current and important issue for Lenders that existing regulations had not contemplated in practical terms. Open lines of communication can highlight to regulators practical issues that Lenders may be facing and provide better guidance for more responsive regulatory action.

b. Role of Investment Advisors and Other Service Providers

Investment advisors and other service providers play an important oversight role in ensuring that Lenders' investment restrictions and objectives are met. These parties, working with the lending agent, can facilitate greater transparency, more effective checks and balances and a lending program that is consistent with the overall investment philosophy and objectives of the investor.

c. Open Dialogue with Agent Bank

Open dialogue is essential to the effectiveness of the agent bank to structure a lending program that meets the return objectives of the Lender and satisfies the Lender's individual risk profile. The ability to provide instructions in a time-efficient manner that is consistent with the standard operations of the Lender is basic to this communication. Periodic reviews of the program, as well as regular, customized reporting and daily access to loan and investment information, ensure transparency and control by the Lender. Finally, maintaining open dialogue will ensure that the securities lending program evolves and remains consistent with the constantly changing (and market sensitive) investment philosophy of the Lender.